COMMODORE INTERNATIONAL LIMITED AND SUBSIDIARIES

MEMORANDUM ON ACCOUNTING PROCEDURES AND INTERNAL CONTROL

JUNE 30, 1983

Philadelphia, Pa.
September 26, 1983.

ARTHUR ANDERSEN & CO.

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FIVE PENN CENTER PLAZA
PHILADELPHIA, PENNSYLVANIA 19103
(215) 241-7300

September 26, 1983

Board of Directors
Commodore International Limited
1200 Wilson Drive
West Chester, Pennsylvania 19380

Gentlemen:

The accompanying memorandum includes suggestions for improvement of accounting procedures and internal accounting control measures that came to our attention as a result of our examination of the consolidated financial statements of Commodore International Limited and consolidated subsidiaries for the year ended June 30, 1983. The matters discussed herein were considered by us during our examination, and they do not modify the opinion expressed in our auditors' report dated August 9, 1983 on such financial statements.

In accordance with generally accepted auditing standards, we performed a study and evaluation of existing internal accounting controls for the purpose of providing a basis for reliance thereon in determining the nature, timing and extent of the audit tests applied in connection with our examination of the Company's 1983 financial statements. While certain matters that came to our attention during the study are presented in the accompanying memorandum for the consideration of management, the study was not designed for the purpose of making detailed recommendations and would not necessarily disclose all weaknesses in the existing system.

Our study, however, did disclose conditions at Commodore Business Machines, Limited (Canada) that we believe to be material weaknesses--that is, weaknesses that result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the audited financial statements of Commodore Business Machines, Limited (Canada) may occur and not be detected within a timely period. These conditions are described in the separate letter dated September 13, 1983, addressed to the Board of Directors of Commodore Business Machines, Limited (Canada).

The accompanying memorandum also includes comments and suggestions with respect to other financial, tax and administrative matters that came to our attention during the course of our examination of the financial statements. These matters are offered as constructive suggestions for the consideration of management as part of the ongoing process of modifying and improving accounting control and other financial and administrative practices and procedures.

Very truly yours,

Arthur Andersen & Co.

PREFACE

This memorandum covers the following locations visited as part of the 1983 audit:

- Commodore International Limited - Corporate
- Commodore Business Machines, Inc. - Systems Division
- MOS Technology

Separate letters or memoranda will be issued to local management of the international subsidiaries visited during the audit.

The comments and suggestions have been grouped by Company and by cycle. Cycles include the following:

- Financial Reporting - General ledger posting, journal entry preparation, consolidation, record control, etc.
- Revenue - Credit granting, order entry, delivery and shipping, billing, accounts receivable, cash receipts, etc.
- Conversion - Cost accounting, manufacturing control, inventory management, property accounting, etc.
- Treasury - Cash management, interest and dividends, debt management, equity transactions, etc.
- Purchasing - Purchasing, vendor selection, receiving, cash disbursement, account distributions, prepayments/accruals, etc.
- Payroll - Payroll accounting and disbursement, labor relations, attendance reporting, etc.

COMMODORE INTERNATIONAL LIMITED

AND SUBSIDIARIES

MEMORANDUM OF ACCOUNTING PROCEDURES

AND INTERNAL CONTROL

SUMMARY OF COMMENTS

COMMODORE INTERNATIONAL LIMITED - CORPORATE

. Standard procedures should be developed to assist local controllers in providing financial information on a more timely basis.

. A separate operating report should be prepared by local companies on a monthly basis.

. The Company should define criteria for classification of research and development expenditures and communicate them to local accounting personnel.

COMMODORE BUSINESS MACHINES, INC. - SYSTEMS DIVISION

. Changes to customer files should be reviewed by supervisory personnel on a timely basis.

. Co-op advertising accruals should be prepared using actual co-op allowances granted.

. Cycle one accounts identified as problem accounts should be moved to cycle three (i.e., collection agency) status on a timely basis.

. A priced-out register of return authorizations outstanding should be maintained.

. Customer credits should be matched to original invoices on a timely basis to keep the accounts receivable trial balance "clean."

. Passwords should be periodically revised to restrict access to critical data files.

*. Effective inventory counting procedures should be implemented and enforced.

Comments and suggestions identified with an asterisk (*) are those that were made in the prior year's memorandum and are repeated since similar situations existed during our recent examination, although possibly to a different degree. Also, during 1983, the Company implemented most of the prior year recommendations and these are not included in the current year report.

*. Proper receiving cutoff procedures should be implemented and enforced.

. Software used in the inventory compilation process should be modified to permit the proper pricing of inventory quantities.

. The detail of in-transit inventory should be reviewed on a timely basis.

. The accounts payable system should be modified to permit the processing of intercompany purchases.

MOS TECHNOLOGY

*. The Company should perform a periodic physical inventory of fixed assets.

Description of Problem	Possible Effect	Suggestion	Management Comments
FINANCIAL REPORTING			
Accelerated Financial Reporting			
At times, the Company experiences delays in the receipt of monthly financial data from the various subsidiaries and divisions. This is in part due to the significant manual effort required to prepare such information at certain of the local companies. In addition, the financial data provided by the local companies is oftentimes revised.	As a result, the Company may be delayed in releasing its financial information for outside reporting. Also, corporate staff may not have sufficient time to analyze and review local company financial information to ensure accuracy and identify potential operating, as well as financial reporting problems.	We recommend that corporate management review current reporting requirements and timetables at specific locations and develop standard procedures to assist local controllers in providing financial information on a more timely basis. Consideration should be given to the automation of this process where appropriate.	Agreed. Efforts are underway to standardize accounting and reporting formats and to upgrade data processing capabilities.
Separate Operational Reporting			
At present, the financial data accumulated for external reporting purposes is the same data available for management information and decision making. The current format of the various reports is dictated principally by external financial accounting and reporting requirements (eg., SEC and FASB).	Certain of this information may not be useful in supporting management decisions which affect operations. In addition, management may not be receiving information needed to support the decision making process.	We suggest that management review existing financial reports and determine changes or additional reporting that should be made. Consideration should be given to the preparation of a separate operating report to be prepared by local companies on a monthly basis.	There has been a program underway for the past few months to accomplish this goal.
Research and Development Expenses			
The Company has not clearly defined what types of expenditures should be classified and reported by subsidiary companies as research and development expenses.	Classification of these expenditures may be handled inconsistently by different subsidiaries resulting in incorrect classification of research and development and other expenses in the financial statements. In the current year, several reclassification entries were necessary to correct this condition.	Corporate accounting should develop a written policy which defines the types of expenditures which should be classified as research and development expenses. This policy should be communicated to local accounting personnel.	Corporate accounting is coordinating with the engineering/research and development group to develop such a written policy.

Description of Problem	Possible Effect	Suggestion	Management Comments
REVENUE			
File Maintenance			
When a customer's file is updated (i.e., credit limit, address change, etc.) a "was-is" maintenance report is not reviewed by supervisory personnel to insure that the change was authorized and is correct.	Without a timely review, a customer's credit limit may be updated incorrectly and may be excessive. A customer's address may be changed in error; therefore, goods would be shipped to the wrong location. Both of these instances may result in uncollectible receivables and/or additional expense.	We suggest that the "was-is" report be reviewed by the credit manager on a timely basis after file maintenance is performed.	Agreed. A general credit manager is in place. Process is currently being performed.
Co-op Advertising Accruals			
During the year, co-op advertising accruals were recorded on the general ledger based on a flat percentage of sales (i.e., approximately 3%). However, actual co-op allowances granted were determined on a different basis (specific allowances, 3% for certain products, etc.)	The differences in accrual methods could result in significant differences in the liability for co-op advertising and the actual expenses incurred by the company. This may necessitate significant adjustments in any one period or result in misstated liabilities on an interim basis.	We suggest that, on a quarterly basis, the co-op advertising allowance be prepared using information supplied by the co-op claims-processing personnel, versus a flat percentage of sales.	Co-op advertising per se has been eliminated. In its place is market development funds. An amount will still be accrued at the rate of 3% of total sales but will be granted only for specific reasons to specific accounts and for varying amounts. During 1983 we had in effect a quasi co-op and quasi market development. The accrual was managed correctly.
Aging Status of Accounts Receivable			
During the year, certain credit department personnel were not reviewing the status of accounts receivable in the cycle-one category (regular accounts) on a timely basis. We noted that the agings of some of the cycle-one accounts had deteriorated; yet, the accounts were not placed in the hands of collection agencies. In other cases, the accounts were placed with collection agencies, but not moved from cycle one to cycle three (collection agency accounts).	Accounts in cycle three are monitored closely regarding their collectibility status. If all of the problem accounts that are with collection agencies, or should be with collection agencies, are not segregated in cycle three, the credit department's review to determine an adequate bad debt reserve may be based on inaccurate information; consequently, the reserve balance may be misstated.	The Credit Manager should insure that all cycle-one accounts are reviewed on a timely basis. Any problem accounts should be sent to a collection agency and moved to cycle three status on a timely basis.	Agreed. This was true during the first half of the year, but not the second half. Once the general credit manager was in place, the administration of the entire credit process was brought up to acceptable levels. In fact, we now have a cycle four which is for accounts placed with the Legal Department.

Description of Problem	Possible Effect	Suggestion	Management Comments
Customer Return Authorizations			
Authorizations issued by Sales Administration for customer returns are not logged in or otherwise controlled. The accounting personnel do not always have accurate and timely data with which to record an accrual.	Without proper control over authorizations issued, the accrual for return credits could be materially misstated.	We suggest that a register be prepared and maintained by Sales Administration listing all return authorizations issued, identifying whether or not goods have been returned and credit has been issued. This register could be used by accounting personnel to efficiently determine an accurate accrual for returns.	As of August 1, 1983, management has set up an automated returns system so that all open authorizations will be treated like an open order; therefore, all pending returns will be known with little manual effort.
Aging of Accounts Receivable			
Per review of the aged accounts receivable trial balance, we noted a significant volume of credit balances issued to customers which were not directly matched to original invoice amounts. This distorts the aging with large over-ninety-day-past-due balances which effectively have been offset by credits which appear in the thirty- or sixty-day-past-due categories.	The aged trial balance does not show a true status of the past-due balances of trade receivables. Management is not provided with accurate information on which to base credit decisions and to assess the adequacy of the bad debt reserve.	We suggest that credit management make a continued effort to "clean up" the aged accounts receivable trial balance by matching customer credits with original invoices.	Account analysts are currently reconciling all accounts to match outstanding chargebacks with credits issued. Management understands there is always reconciliation to be done on accounts, due to customers deducting returns, shortages, advertising allowances, etc., prior to proper documentation being sent to CBM Inc. Actions are being taken to eliminate deductions being taken in an unauthorized manner.
Password Security			
The Company utilizes password controls to restrict access to its on-line system. We discussed the use of passwords with certain personnel and noted that in some cases the individuals could access menu items that they are not normally allowed to access with their password. These individuals' functions had recently changed; however, the passwords had not been updated to restrict access.	Unauthorized personnel could access data through the use of passwords from their former positions.	We suggest that EDP management periodically revise passwords to prevent unauthorized access to data files.	Management feels that responsible personnel reviewing exception reports will note any unusual or unauthorized changes made to data files. However, EDP management is in the process of changing passwords.

Description of Problem	Possible Effect	Suggestion	Management Comments
CONVERSION Physical Count In connection with our inventory observation at West Chester for May 31, 1983, the following comments relating to the physical count are noted:			
. A pre-inventory meeting with both accounting and warehouse supervisors and count teams to insure that all instructions were understood was not held. . In several instances, count teams did not appear to be assigned areas in the most efficient manner (one individual counting a large area alone). . Areas were not being checked by supervisors to insure all items were tagged and all counts were accurate. . Inventory items of different departments (customer returns, software production, etc.) were stored in the same area and counted by different teams. . Part numbers on tags for software items did not clearly indicate whether the inventory was raw material or finished goods. Specifically, empty cartons used to package cartridges were not recorded clearly; thus tags were compiled as representing packaged finished cartridges. (A yearend physical count of the software inventory was taken, since the May 31, 1983, count was deemed unreliable.)	As a result of these items, the possibility of an inaccurate count is greatly increased. This would result in an improper book-to-physical adjustment being included in cost of sales and a misstatement of the inventory balance.	We suggest that management implement and enforce detailed inventory-count procedures, including the following: . Pre-inventory meeting of all personnel involved in the count to insure procedures are understood. . Proper supervision to insure procedures are followed. . Physical segregation of inventory items by responsibility areas. . Organization of the areas before counting begins. . Efficient utilization of personnel familiar with the inventory they are assigned to count. . Tag controls should be compared to actual tags by cost accounting personnel to insure unauthorized changes were not made. Any differences should be promptly investigated.	Since January 1983 when warehousing commenced at West Chester, inventories have been taken on a monthly basis. By May inventory, all supervisors were trained in the inventory taking process. The major problem with the yearend inventory in May was that space was still being allocated to the various areas of inventory responsibility as well as the fact that we were in an overflow condition which put an additional burden on the inventory taking process. Recognizing the May situation, we took an inventory in June to verify the accuracy of the May physical count. The inventory remained accurate. With the start-up problems behind us, the inventory taking process each month is disciplined within the control levels of generally accepted inventory taking guidelines.

Description of Problem	Possible Effect	Suggestion	Management Comments
Physical Count (Continued)			
*. The status (i.e., voided, unused, etc.) for several tags on the tag control differed form the status in the priced-out physical listing and on the individual tags themselves.			
. Warehouse personnel responsible for specific areas had left the plant before all counting and tag control listings had been completed. This resulted in additional time spent by others, less familiar with the areas and tags issued, to complete the task.			
Inventory Cutoff			
The following observations relating to the Company's control over the May, 1983 receiving cutoff are noted:			
. Four separate receiving logs are maintained in the receiving area; these are segregated by type of item received. For the finished goods inventory log, receiving information for approximately ten days' receipts was not included in the log. *. Receiving reports were not used in numerical sequence, resulting in some confusion over which receipt was the last before the cutoff. . Inventory received after the cutoff was stored in the warehouse and not clearly marked as "after inventory." This created confusion as to whether the items should be counted.	Inadequate cutoff procedures could result in incorrect book-to-physical adjustments. Consequently, the inventory balances are less reliable.	We suggest that management strictly enforce proper receiving and shipping controls and cutoff procedures including the following: . One consolidated receiving log accurately completed on a timely basis. . Strict numerical control over receiving reports.	One overall receiving log is being used to record all receipts. Then, separate logs by inventory type (hardware, software, customer returns, etc.) are prepared from the one log to support the respective inventory perpetual records. Also, a management representative now spends the first day after cutoff on the receiving dock to ensure all receipts are marked "after inventory."

Description of Problem	Possible Effect	Suggestion	Management Comments
Inventory Compilation			
The unit costs used to price the physical inventory are rounded to two decimal places in the compilation. Thus, for the items costed at a fraction of a cent, the inventory is not extended. This results in a significant effort to manually price-out certain inventory items.	There is an increased margin for error and misstated inventory balances could result.	We suggest that EDP management make the necessary modifications to the software program in order to cost all inventory items with the automated process.	The Honeywell system was used for the yearend inventory. Plant accounting recognized the limitations of the Honeywell's software and placed "0" cost in the file for those items with less than $.01 cost. They then manually extended the dollar value of these items. The IBM is being used presently, and appropriate software modifications are being made to permit the automated compilation of items with less than $.01 cost.
In-Transit Inventory			
The detail of in-transit inventory as of the physical date showed a significant balance of inventory shipped to West Chester two or three months previously. The detail had not been reviewed to determine if these items had already been received.	If the items have been received and still recorded as in-transit, the inventory balances would be overstated.	We recommend a timely review of the in-transit inventory items be performed to remove items received from the in-transit account.	In-transit inventories are reviewed each month. At the end of each quarter and at year-end physicals they are thoroughly reviewed. That the in-transit was not being reviewed is somewhat inaccurate in that AA&Co. personnel and our personnel were reviewing the accounts simultaneously. Prior to closing our books we would have done a thorough review. We do agree that we have had some problems in the receiving area which have since been remedied. Traffic Department is tracing all shipping advices from shipment to actual receipt, and at monthend plan accounting, traffic and receiving reconcile the in-transit account.
PURCHASING			
Intercompany Purchases			
All intercompany inventory purchases are processed manually and are accrued at standard cost. The manual effort is significantly time consuming due to the volume of intercompany transactions.	Manual processing of large volumes of purchases is less efficient with an increased margin for error. The accrual balance for intercompany purchases for any one period, and the related cost of sales variances, could be materially misstated with inventory accrued at standard.	We suggest that management implement the necessary modifications to the accounts payable system to include intercompany purchases and record them at actual costs.	It is agreed that there are a large number of inter-company transactions processed manually each month, but we believe that our procedures are adequate for maintaining proper inventory balances and the elimination of the variances from standard.

Description of Problem	Possible Effect	Suggestion	Management Comments
CONVERSION			
Fixed Assets Observation			
The Company does not perform a periodic physical inventory of fixed assets. The cost of such assets at June 30, 1983 was $27,200,000.	General ledger balances may need adjustments to reflect physical assets on hand.	Periodic physicals of fixed asset balances should be performed and general ledger adjustments recorded as required.	Recently, an individual was assigned the task of systemizing the recording and cataloging of fixed assets. He has already started working on the system layout. When this phase is completed, the reconciliation and adjustment process will take place.